



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

February 15, 2006

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2005. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,628 active members and 4,665 retirees participating in the ERS as of June 30, 2005.

Performance Results

The total return achieved by the ERS assets for the quarter was 1.83%, slightly behind the 1.92% return of the policy benchmark. For the one year period ending December 31, the ERS' gross return (before fees) was 7.17%, 23 bps. ahead of the 6.94% return of the policy benchmark. The strong one-year return places the ERS' performance in the top 40% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 14.52%, after fees, ranking in the top 14% of the universe. The asset allocation at December 31, 2005 was: Domestic Equities 48.8%, International Equities 16.4%, Fixed Income 23.6%, Inflation Linked Bonds 9.7%, Alternative Investments 1.4% and Cash 0.1%.

Major Initiatives

During the quarter, the Board conducted a search for high yield fixed income bond managers which resulted in the selection of two firms, Loomis Sayles and Nomura, who will manage a total of 5% of the System's assets.

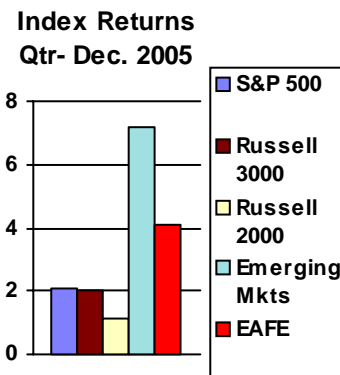
Other actions by the Board include: evaluation of currency management strategies and the decision to conduct a search for a manager to assist in implementing a risk control strategy relevant to international investing, approval of the FY 2006 estimated and FY 2007 requested budgets, issuance of the Board's FY 2005 annual report, continued work on establishing a risk budget and expansion of the Board's risk management program.

QUARTERLY REPORT

Capital Markets and Economic Conditions

Economic reports released during the fourth quarter continued to show above-trend growth across the U.S. economy, subdued inflation, and a bounce in consumer confidence from the low levels in the summer. GDP growth climbed by 4.1%, continuing a string of 8 consecutive quarters of 3%+ growth. The Federal Reserve increased short-term interest rates during the quarter to a level of 4.25% and removed the previously used “accommodative” wording from its policy statement causing many economists to predict a near-term end to the Fed’s rate increases. Commodity prices gave back some of the large gains during the quarter, as natural gas and crude oil prices dropped by 19% and 8%, respectively. However, metals climbed higher with gold rising 10% to \$517/ounce. The dollar was helped against other major currencies by higher interest rates in the U.S., rising 1.5% against the Euro and 3.7% against the Yen.

As shown in the chart to the right, the U.S. equity markets moved higher during the quarter with the broad indices, such as the S&P 500, up around 2%. The market was supported by lower energy prices and relatively strong economic reports during the month; however, worries over consumer spending, the effect of an inverted yield curve, and increasing geopolitical instability limited gains. The best performing sectors in the Russell 3000 Index were materials, +6.5%, financials +6.1% and consumer discretionary +3.6%. Equities within the integrated oils sector posted the largest loss, down 11.9% for the quarter due to 10% or greater declines in share prices of ExxonMobil, Chevron and Conoco. Growth stocks outperformed value stocks and large cap stocks outperformed small cap stocks during the quarter. Our combined domestic equity performance was a gain of 1.96%, 8 basis points behind the Russell 3000 benchmark index return of 2.04%. For the one year period ending December 31, our combined domestic equity performance was 6.95%, over 80 basis points ahead of the return achieved by the Russell 3000 benchmark index.



Within developed international markets, Japanese stocks strongly outperformed other indices as positive economic reports and increasing corporate reforms helped the Nikkei to climb by 18.7% in local terms, 14.4% in dollar-terms. European markets were higher with the best performing markets being Switzerland +8%, Ireland +6% and Germany +6% as low bond yields, falling energy prices and signs of economic improvements helped equity investors. Emerging markets climbed 7% during the quarter as shares in South Korea, Indonesia, Russia and Mexico all rose by greater than 10%. Our combined international equity performance was a gain of 3.86% for the quarter, 53 basis points behind the benchmark index return of 4.39%.

Late in the quarter the yield curve became inverted for the first time since 2000 as the yield on the two-year Treasury moved higher than the yield on the ten-year Treasury. All major domestic fixed income sectors showed positive returns with Treasuries +0.73% outperforming most other fixed income sectors. Within the high-yield sector, higher quality securities outperformed. Our combined fixed income return for the quarter was a 0.51% compared to the 0.59% recorded by the benchmark index. For the one year period ending December 31, our total fixed income performance was 2.51% versus the 2.47% return of the benchmark. ERS investments in Inflation-Linked bonds recorded a gain of 0.96% for the quarter and 6.71% for the one year period ending December 31.

Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending December 31, 2005 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	<u>Qtr</u> <u>12/31/05</u>	<u>Fiscal</u> <u>YTD</u>
Employer Contributions	\$ 22.0	\$ 44.1
Member Contributions	4.0	8.3
Net Investment Income	<u>38.5</u>	<u>121.4</u>
	\$ 64.5	\$173.8

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System Deductions by Type (millions)

	<u>QTR</u> <u>12/31/05</u>	<u>Fiscal</u> <u>YTD</u>
Benefits	\$ 31.0	\$ 61.7
Refunds	.2	.3
Administrative Expenses	<u>.5</u>	<u>1.0</u>
	\$ 31.7	\$ 63.0

Outlook

The economy has bounced back from several shocks over the past year, including a severe hurricane season, rapidly increasing energy prices, renewed geopolitical pressures and a housing market that is beginning to slow down. Looking forward, the ability for consumers to continue to spend, or for businesses to increase spending, will be vital to whether the economy is able to continue to grow at the same rate. Forecasts are for consumers to continue lowering the amount of cash taken out from refinancing their homes due to increasing interest rates. The Federal Reserve will likely end their steady increase in short-term interest rates sometime during the spring or summer months in order to gauge the resilience of consumers and businesses.

QUARTERLY REPORT

EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

December 31, 2005

Assets

Equity in County's pooled cash and investments	\$ <u>401,593</u>
Investments	
Northern Trust	2,511,345,332
Aetna	10,468,807
Fidelity - Elected Officials Plan	<u>791,685</u>
Total investments	<u>2,522,605,824</u>
Contributions receivable	<u>6,107,230</u>
Total assets	<u>2,529,114,647</u>

Liabilities

Benefits payable and other liabilities	<u>273,511,312</u>
Net assets held in trust for pension benefits	\$ <u>2,255,603,335</u>

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**

December 31, 2005

Additions	Quarter	Fiscal YTD
Contributions		
Employer	\$21,986,047	\$44,086,456
Members	<u>4,022,224</u>	<u>8,307,051</u>
Total contributions	<u>26,008,271</u>	<u>52,393,507</u>
Investment income	40,465,864	125,196,980
Less investment expenses	<u>1,996,269</u>	<u>3,799,907</u>
Net investment income	<u>38,469,595</u>	<u>121,397,073</u>
Total additions	<u>64,477,866</u>	<u>173,790,580</u>
Deductions		
Retiree benefits	28,904,543	57,238,315
Disability benefits	2,007,281	4,072,846
Survivor benefits	127,979	385,746
Refunds	135,493	300,631
Administrative expenses	<u>503,395</u>	<u>968,910</u>
Total deductions	<u>31,678,691</u>	<u>62,966,448</u>
Net increase	<u>32,799,175</u>	<u>110,824,132</u>
Net assets held in trust for pension benefits		
Beginning of period	<u>2,222,804,160</u>	<u>2,144,779,203</u>
End of period	<u>\$2,255,603,335</u>	<u>\$2,255,603,335</u>